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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

Washington, D.C.

In the matter of:	)	
	)	
Implementation of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

REPLY COMMENTS OF THE MEDIUM-SIZED OPERATORS GROUP

Adelphia Communications Corporation
Bresnan Communications Company
Cablevision Systems Corp.
Columbia International, Inc.
Falcon Cable TV
Hauser Communications
InterMedia Partners
Jones Spacelink, Ltd.
Lenfest Communications, Inc.
Marcus Cable
Prime Cable
RP Companies, Inc.
Simmons Communications, Inc.
Star Cablevision Group
Sutton Capital Associates
Triax Communications Corp.
United Video Cablevision, Inc.
US Cable Corporation

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Dated: September 14, 1993

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SUMMARY

The Medium-Sized Operators Group submits the following reply comments regarding cost-of-service standards and procedures. As stated in the Group's initial comments and developed further herein, transitional rules are necessary in order for the FCC to develop a rate structure that complies with Constitutional standards. The FCC must recognize that, for the initialization of cable rates, the incentives that existed for cable operators in a unregulated environment do not trigger the policy concerns that typically exist under rate of return regulation. Therefore, an appropriate transitional rule would allow operators to base their cost-of-service showings on historical financial data taken from audited financial statements.

In addition, the Group is submitting Ernst & Young's report "Cost-of-Service Regulation for Cable Operators" which discusses the findings of E&Y's extensive cost-of-service analyses of nine (9) cable systems operated by certain of the Group's members. E&Y's evaluation confirms that, if the FCC adopts its proposals to exclude from the rate base intangibles, accumulated losses and income taxes for partnerships and Subchapter S corporations, six of these systems will not recover all of their existing depreciation expenses, and only one would recover amortization of existing intangibles.

E&Y also undertook an analysis of whether intangibles are commonly found in other industries for reasons unrelated to

market power. As discussed herein, E&Y found that: (1) half of the publicly-traded companies evaluated reported intangible assets; (2) the average ratio of intangible to total assets for the radio broadcasting firms was 56%, compared with 29% for the cable companies surveyed; and (3) acquisition premiums paid for some firms in competitive markets were as high or higher than premiums paid for cable television assets.

Finally, E&Y examines patterns of accumulated losses found in the cable industry, depreciation and income tax issues, and application of price caps on a going-forward basis.

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REPLY COMMENTS OF THE MEDIUM-SIZED OPERATORS GROUP

The medium-sized operators group[1] ("the Group"), by its attorneys, hereby submits the following reply comments on the Federal Communications Commission's ("FCC or Commission") Notice of Proposed Rulemaking, ("NPRM") FCC 93-353, MM Docket No. 93-215 (released July 16, 1993) on cable television cost-of-service standards.

I. INTRODUCTION

On August 25, 1993, the Group filed comments in this proceeding urging the FCC to: (1) allow a cable operator to initialize regulated rates based on the market value of the cable system (rather than at "original cost"); (2) recognize that intangible assets comprise a significant portion of a cable system's market value (i.e., the acquisition price) which

[1] The members of this group include: Adelphia Communications Corporation, Bresnan Communications Company, Cablevision Systems Corp., Columbia International, Inc., Falcon Cable TV, Hauser Communications, InterMedia Partners, Jones Spacelink, Ltd., Lenfest Communications, Inc., Marcus Cable, Prime Cable, RP Companies, Inc., Simmons Communications, Inc., Star Cablevision Group, Sutton Capital Associates, Triax Communications Corp., United Video Cablevision, Inc., and US Cable Corporation.

requires the adoption of transitional rules to ensure that operators are able to meet their present debt obligations; (3) recognize that cable operators incur substantial start-up operating losses and allow operators to include these costs in the rate base; (4) allow operators to determine depreciation rates based on GAAP rather than adopting federally-prescribed standards; (5) not adopt a uniform system of accounts for cable operators; (6) provide for an income tax allowance regardless of ownership structure; (7) allow operators to generally allocate costs between regulated and unregulated services based on the cost allocation rules adopted in the Report & Order[2]; and (8) recognize that the substantial majority of the costs associated with upgrades required as a result of the new technical and customer service standards, and with fiber optic rebuilds that enhance the quality of the essential distribution plant, are properly allocable to the regulated tiers.

The majority of cable operators filing comments in this proceeding made similar recommendations. The record clearly establishes that there is no basis for the FCC to presume that acquisition costs incurred in an unregulated environment reflect monopoly profits. Moreover, valuing the rate base under an original cost methodology would be confiscatory,[3] and impossible

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[2] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, FCC 93-117, MM Docket No. 92-266, released May 3, 1993.

[3] See, e.g., Comments of Cable Operators and Associations at p.20-21.

to implement because the necessary records are not available to the majority of cable operators.[4] The record also establishes that substantial start-up operating losses are inherent in the cable industry, and that these losses must be allowed to be recovered in the rate base in order to preserve the necessary incentives for future investment.[5]

As indicated in the Group's comments, the Group retained Ernst & Young (E&Y) to conduct extensive cost-of-service analyses of nine (9) cable systems operated by certain of the Group's members representing a wide range of cable system characteristics. The findings of E&Y are discussed in the attached report "Cost-of-Service Regulation for Cable Operators." The E&Y report evaluates the need for transitional rules, and examines the impact of the proposed rules on the specific systems evaluated. E&Y also undertook an analysis of whether intangible assets are commonly found in other industries for reasons unrelated to market power, and the extent to which acquisition premiums are paid in both competitive and non-competitive market settings. In addition, E&Y discusses streamlined procedures to initialize regulated rates. Finally, E&Y examines patterns of accumulated losses found in the cable industry, depreciation and income tax issues, and application of price caps to regulated cable rates on a going-forward basis.

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[4] See, e.g., Comments of Cable Operators and Associations at p.65; Comments of Cable TV of Georgia et al, at p.19.

[5] See, e.g., Comments of Cablevision Systems Corporation at p.31.

In addition to discussing the E&Y report, the Group takes this opportunity to respond to certain issues raised by other parties in this proceeding and address an issue raised by the Commission in its First Order on Reconsideration, Second Report & Order, and Third Notice of Proposed Rulemaking,[6] regarding external treatment for upgrades and rebuilds required to comply with federal technical and customer service standards.

II. INITIALIZATION OF RATES

A. Transitional Rules are Required

The initial comments filed in this proceeding illustrate the need for transitional rules. As previously discussed by the Group and most other commenters, an immediate application of traditional rate of return regulation will cripple the cable industry, violate Constitutional standards relating to the confiscation of property,[7] and violate the specific statutory provisions of the 1992 Cable Act which require the FCC to regulate rates based on actual costs incurred by cable operators in the provision of cable television service.[8] Specifically, implementation of the FCC's proposal to exclude intangibles, accumulated losses and income taxes for partnerships and Subchapter S corporations will not generate sufficient

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[6] "First Order on Reconsideration", FCC 93-428, MM Docket No. 92-266, released August 27, 1993.

[7] See, Initial Comments of the Group at p.6-10.

[8] See, Sec. 3(b)(2)(C) of the 1992 Cable Act. See also, Sec.2(b)(3) requiring that the FCC "ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems."

revenue for six of the eight cable systems evaluated herein to recover all of their existing depreciation expenses, and only one would recover amortization of existing intangible assets. See, E&Y Report at p.22 and Table 6.

Transitional rules to initialize cable rates are absolutely required. Otherwise, as demonstrated in Table 6, many of the Group's members will not be able to meet existing debt obligations, much less make necessary capital improvements. Capital expenditures for upgrades and rebuilds alone between 1985 and 1992 by the Group's members in the nine systems reviewed by E&Y totalled more than $342 million. See, E&Y Report, Table 3. If the FCC's cost-of-service rules do not allow operators to recover their existing debt and accumulated losses, it will be problematic for these operators to continue to upgrade and rebuild their systems.

As discussed in more detail by E&Y, the FCC can adopt transitional rules without affecting future incentives by ensuring that price caps will be the primary method of regulation on a going-forward basis. See, E&Y Report at p.2. Moreover, streamlined cost-of-service procedures are appropriate for initializing regulated rates. Because cable operators have not been subject to rate of return regulation, there have been no incentives to artificially inflate costs, and no such inflation has occurred. As a result, simplified cost-of-service showings using a historical "test year" taken from audited financial statements should be permitted by the Commission. See, E&Y Report at p.5. Allowing this type of streamlined procedure and using price caps on a going-forward basis obviates the need to prescribe depreciation rates, adopt a uniform system of accounts and establish complicated cost allocation rules. See, E&Y Report at p.5 and p.42-43.

B. Intangible Assets

As noted above, the Group asked E&Y to determine the level of intangible assets found in competitive industries, and examine the relationship between acquisition premiums and market power. E&Y found that half of 5,264 publicly traded companies identified in the Compustat data base report intangible assets, and that competitive firms report intangibles nearly as often as firms that may possess market power ("other firms"). E&Y Report at p.7-8. The range of reported intangibles was between zero and 98%, and the average ratio of intangible to total assets for competitive firms and for other firms was 11% and 14%, respectively.[9]

Significantly, radio broadcasting firms, which operate in competitive markets and derive revenues based on audience share (akin to cable subscriber lists), reported intangible ranging from 33% to 78% of total assets, with the average being 56%. Id. at p.9. For cable television companies, the range was zero to 77%, with an average of only 29%. Id.

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[9] Id. Note that "pre-operating expenses" and "start-up" costs are specifically excluded from Compustat's classification of intangibles. If these items were included in the data base it is likely that the incidence and level of reported intangibles would be even higher. E&Y Report at p.7, n.4.

With respect to the issue of acquisition "premium" over book value, E&Y found that acquisition premiums were paid in a wide variety of industries, and that the premiums paid for firms in competitive markets were not much higher than premiums paid for other firms. See, E&Y Report at p.10. Specifically, E&Y found that premiums paid for some firms in competitive markets were as high or higher than premiums paid for cable television assets. Id.

Furthermore, as E&Y discusses, there is no reliable method for estimating the portion of "excess acquisition cost" that is attributable to expectations of monopoly profits. E&Y Report at p.11. Therefore, intangibles should be presumed to be legitimate and fully included in the rate base provided they are in accordance with GAAP.

C. Accumulated Losses

The recovery of accumulated losses is necessary to maintain the financial viability of the Group's members. As shown in Table 1 in the E&Y Report, all of the nine systems examined by E&Y had accumulated losses as of December 31, 1992. In spite of the existence of these losses, all of these systems have been upgraded and/or rebuilt since they were acquired. See, E&Y Report, Tables 2 and 3. The total capital expenditure for the upgrades and rebuilds described in Tables 2 and 3 was over $342 million. It is clear that these investments were made with the reasonable expectation that they would eventually be recovered.

As illustrated in Table 5 of the attached E&Y Report, for all nine systems operated by Group members, the number of homes passed, subscribers, and penetration have increased significantly since 1983. This pattern of growth is similar to that of Media General, which submitted similar information. See, E&Y Report p.19 and Table 4. Despite this growth, the Group's systems still have not reached the point of positive net income. Id. Adoption of the FCC's proposals at this stage of these systems' development would not only preclude these operators from ever recovering these losses, but also impair operators' ability to fund future upgrades and rebuilds. As E&Y states, "If cost-based prices exclude amount designed to recover, over time, intangibles and accumulated losses, then these past investments are effectively confiscated." Id. at p.22. Moreover, the magnitude of these past investments are such that they cannot be recovered from revenue from unregulated services. Id.

The FCC must allow operators to amortize past losses that exist on the date of initial regulation over a reasonable period of time. This would include such amounts representing unrecovered costs of depreciation, franchise rights, subscriber lists, and developmental efforts.

D. Depreciation and Income Taxes

As the Group proposed in its initial comments, GAAP should be used as the basis for justifying historical expense levels and asset values. There is no need for the FCC to prescribe depreciation and amortization rates. See, E&Y Report at pp.26-33. As discussed in detail by E&Y, GAAP and existing cable company practices provide adequate constraints over cable rates, the administrative burden required to prescribe depreciation rates far outweighs any perceived benefits, and existing cable company depreciation rates and practices are not dissimilar to those found in the telephone industry. Id.

The Group also strongly opposes the FCC's proposal to prohibit a tax allowance for partnerships, Subchapter S corporations and sole proprietorships.[10] As discussed more fully by E&Y, the FCC's proposed policy is inequitable and ignores the fact that these types of business entities have substantial tax burdens, albeit indirect. See, E&Y Report at p.34-41.

III. RATE OF RETURN

The Group believes that the FCC should adopt a single "unitary" rate of return for the cable industry. In adopting a unitary rate of return for the Local Exchange Carriers ("LECs") the FCC stated that prescribing individual rates of return for the 1,400 LECs would be administratively infeasible, and that the LECs, as a whole, faced similar risks in providing telephone service.[11] A unitary rate of return was adopted by the FCC in

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[10] Initial Comments of the Group at p.24.

[11] Authorized Rate of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, "Phase II Order," 59 Rad.Reg.2d (P&F) 651 (1985), aff'd., 60 Rad.Reg.2d (P&F) 1561 (1986).

spite of the FCC's recognition that the LECs had different capital structures and different levels of embedded debt. Id.

The Group submits that allowing franchise authorities to prescribe a rate of return on a system by system basis for the more than 11,000 cable systems in the country may well result in over 11,000 different rate prescriptions. The FCC, with its expertise in this area, is the most competent entity to prescribe a single federal rate of return. As the Commission has stated, the adoption of federal, uniform cost-of-service standards will enable the FCC to properly balance the interests of consumers and cable operators, and will avoid multiple standards. Report & Order at ¶ 270. Moreover, the Group agrees with the FCC's tentative findings in the cost-of-service NPRM that it would not be possible to establish separate rates of return for each cable company. NPRM at ¶ 46.

However, the Group believes that the FCC's proposed rate of return (between 10% and 14%) is far too low. The 10% to 14% range was based on the FCC's initial analysis of the S&P 400 index applied as a surrogate for the cable industry. As the initial comments in this proceeding overwhelmingly asserted, the S&P 400 index is not an appropriate surrogate for the cable industry. The Group agrees with these commenters that the rate of return should be approximately 18% - 20%.[12]

[12] See, e.g., Comments of Cable Operators and Associations at p.85.

Most importantly, the FCC must take into account the significant and unique risks faced by the cable industry, particularly in the wake of the 1992 Cable Act. As CATA pointed out in its comments, investor risk in the cable television industry has been greatly increased by the Act. Specifically, the FCC must consider the impact of: (1) the up to 10% mandatory reduction of cable rates under the benchmark regime; (2) operators' uncertainty of whether cost-based regulation will generate sufficient revenues for upgrades and rebuilds; (3) the forced carriage of television stations with narrow audience appeal; and (4) the impact of broadcast retransmission and related consent fees.

IV. <u>REGULATORY PARITY</u>

The Comments submitted by the various telephone companies ("telcos") in this proceeding rely almost entirely on policy arguments which they fail to support in any substantive way.[13] In general, they urge the Commission to adopt cable regulations that ensure "regulatory parity" between the cable and telephone industries. The telcos' rationale for this request seems to be a "misery loves company" type of argument. For example, Nynex asserts that original construction cost is the proper method of valuing the cable companies' rate base because

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[13] Bellsouth and The National Telephone Cooperative Association ("NTCA") did not provide any economic studies to support their Comments in this proceeding. Nynex provided some economic data from Dr. James Vanderweide. However, he provided no factual support for Nynex's assertions that "original cost" should be used, and that the rate base should exclude "excess acquisition costs" and intangibles. Id. at ¶ 26-35.

"the Commission applies the net original cost standard to telephone companies."[14]

The telcos themselves note that the telecommunications and cable industries are "rapidly converging" and "increasingly competitive" with each other.[15] This trend of increasing competitiveness between the two industries reduces the justification for traditional rate of return regulation. The Commission must adopt a regulatory structure that accounts for the changing marketplace and which nurtures emerging competition, rather than stifles it.

Moreover, the telcos largely ignore the need for transitional rules. The historical fact remains that cable television has not been subjected to rate of return regulation, and unlike the telephone industry, it does not have a uniform system of accounts, similar ownership structures, similar debt obligations, etc. Cable television is simply not a monolithic public utility which requires common carrier-type rate regulation.

V. EXTERNAL TREATMENT OF REBUILDS AND UPGRADES

On August 27, 1993, two days after the Group submitted its initial comments in this proceeding, the FCC released the

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[14] Nynex Comments at p. 23. Even James H. Vanderweide, Nynex's economist, could not find a more important reason. Affidavit of James H. Vanderweide at Paragraph 29 (stating that "[m]ost importantly, net original cost is the standard used by regulators for valuing plant in service in the telecommunications industry.")

[15] See Comments of Nynex et al. pp. 4-9; Comments of GTE at pp. 7-12; Comments of Bellsouth at pp. 3-5.

First Order on Reconsideration, supra, regarding benchmark rate regulations. The FCC clarified that the costs of meeting federal customer service and technical standards will not be afforded external treatment to the benchmark rates. Id. at ¶ 102. However, the "increases in the costs of complying with services specifically required in the franchise documents will be eligible for external treatment," including the costs associated with meeting local franchise technical and customer service requirements that exceed federal standards. Id. The question of whether upgrades required by the franchise authority should be afforded external treatment will be considered in the Third NPRM. Id. at n.176 and ¶¶ 153-154. The Group will be addressing this issue and others in response to the FCC's Third NPRM.

The FCC's distinction between federally-imposed costs and locally-imposed costs is arbitrary and capricious. The Commission's entire rationale for allowing external treatment for certain costs is the fact that such costs are beyond the control of the operator. Report & Order, supra, at ¶ 254. Both types of such mandatory costs are beyond the control of the operator and should be passed-through to subscribers. Moreover, the pass-through of such costs will provide incentives to operators to further the 1992 Cable Act's policy goal of developing the telecommunications infrastructure. Encouraging the deployment of fiber optics will create operating efficiencies and reduce maintenance and other costs in the long term. Therefore, it benefits both subscribers and cable operators to encourage upgrades and rebuilds.

As the Group discussed in its initial comments, the costs of meeting the 1992 technical standards and customer service requirements are not only external costs, but benefit all subscribers by enhancing the essential distribution plant. The substantial majority of the cost of upgrading to fiber optics is thus properly attributable to the regulated tiers, with only the incremental costs allocable to the unregulated tiers. See, Comments of the Medium-Sized Operators Group, August 25, 1993, at p.27 and Declaration of David Large attached thereto.

Accordingly, the Group submits that the FCC should reconsider its decision to not afford external treatment to the costs associated with complying with federal technical and customer service requirements, and urges the FCC to afford such costs the same treatment as costs associated with complying with state and local requirements. There is no rational basis to treat these costs differently.

VI. CONCLUSION

The Group emphasizes that the initialization of cable television rates does not trigger the same concerns as establishing rules governing the future incentives of cable operators in a rate of return regulatory environment. As discussed by E&Y, the undesirable incentives that can be created by rate of return regulation do not exist when a rate is being initialized. Specifically, cable operators have not had incentives to artificially inflate costs historically. In fact, the incentives were exactly the opposite -- to reduce costs. Therefore, it is reasonable to permit cable operators to rely on historical financial information taken from audited financial statements. This approach not only provides for an effective transition mechanism, but will also reduce the administrative burden for franchise authorities, the FCC, and cable operators. Imposing traditional rate of return regulation, (e.g., establishing depreciation schedules, and a uniform system of accounts) for the initialization of rates will substantially delay the outcome of this rulemaking well beyond the time frame necessary for cable operators to have final rules in place in order to respond to franchise authorities' notifications of initial regulation.

Based on the foregoing, the Group respectfully requests that the FCC incorporate the proposals outlined herein in its final rules governing cost-of-service standards.

Respectfully submitted,

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Cost-of-Service Regulation for Cable Television Operators

September 13, 1993

ERNST & YOUNG

Cost-of-Service Regulation for Cable Television Operators

Ernst & Young

Introduction and Summary

In response to the July 16, 1993 Notice of Proposed Rulemaking in MM Docket No. 93-215 (NPRM), the Medium-Sized Operators Group (the Group) engaged Ernst & Young to study the impact of the Federal Communications Commission's (FCC or Commission) proposed cost-of-service (COS) rules on the cable operators in the Group. This paper presents the results our study.

Much has been written about the deficiencies of traditional rate-base/rate-of-return regulation. In particular, many experts have observed that the "cost-plus" nature of traditional regulation does not give companies sufficient incentive to minimize costs for a given level and quality of service. The criticisms are reiterated in papers in this proceeding sponsored by Time Warner Entertainment Company, L.P. ("A Proposal for Backstop Regulation for Cable Television Prices," National Economic Research Associates, August 25, 1993) and by Tele-Communications, Inc. ("An Analysis of the FCC's Proposed Cable Cost-of-Service Backstop," Charles River Associates, August 24, 1993). The Commission has previously recognized the deficiencies in traditional rate-base/rate-of-return regulation and has provided greater incentives for efficiency in its system of price cap regulation for AT&T and the Local Exchange Carriers (LECs). (See, for example, parts 61.41-61.49 of the Commission's *Rules and Regulations.*)

The Commission has stated that it believes cost-of-service regulation will be used as a secondary alternative, or backstop, in its regulation of cable television rates. The benchmark formula and FCC Form 393 will be the primary vehicle for establishing (or "initializing") regulated rates. The Commission expects that most cable operators will use the benchmarks, rather than COS studies, to justify their initial regulated rates. Thereafter, a price cap formula will be the primary vehicle for regulating changes in rates over time. Again, the Commission expects that most cable operators will choose to be regulated under a price cap, rather than file annual COS studies to justify rates.

Nevertheless, COS regulation has two potential uses in the Commission's system of rate regulation of cable service tiers: first, as an alternative to benchmarks for initializing regulated rates, and second, as an alternative to price caps for changing regulated rates. The Commission should clearly distinguish between these two uses of COS regulation, because the purposes are very different and therefore policies and safeguards must be different. The criticisms directed at the "bad" incentives of rate-base/rate-of-return regulation are primarily concerned with future incentives—how regulation affects decisions when there is a regulatory linkage between changes in costs, prices and profits. When COS studies will be used to justify changes in rates over time, regulators must consider policies to counterbalance such incentives.

The same undesirable incentives do not exist, however, where a regulated rate is being initialized. In the case of cable operators which have not operated to date under rate-base/rate-of-return incentives and have had no incentive to artificially inflate costs, rates can be initialized using historical costs. As long as future rate changes are not based on COS, undesirable incentives that accompany COS ratemaking will simply not be relevant. Where regulated rates are initialized based on COS, but subsequent changes are made under a price cap formula, the operator has incentives to make cost-efficient decisions. This is the regulatory approach used by the Commission when establishing price caps for AT&T and the LECs.

The members of the Group are concerned with COS procedures both for initializing rates and for changing rates in future years. Their primary concern, however, is to initialize regulated rates at levels that provide fair compensation and reasonable incentives to invest in their systems and improve the quality of services. The transition to rate regulation should recognize the substantial investments already made, and provide the opportunity to recover these investments.

The cable industry is in transition to a new system of regulation. Initialization of regulated rates should take into account the difficult, and potentially disruptive, effects of implementing this new system of rules and incentives. Cable operators implemented new rates on September 1, 1993 designed to comply with the new rate regulations, including the rate freeze in effect since April 1, 1993. Cost-of-service rules for justifying these initial rates should recognize the unique issues of a difficult transition, such as the existence of substantial intangible assets that were acquired prior to regulation in arms length transactions, as well as existing loan agreements, bond indentures and forms of ownership. Also, cost-of-service showings to justify these initial rates should proceed expeditiously, in order to avoid the cost and uncertainty of prolonged regulatory proceedings.

The Commission can take the transition issues into account without affecting future incentives, by adopting transitional COS methods for initializing rates and by affirming that price caps will be the primary method of regulating changes to the initial rates. The COS transition procedures should be used for justifying the initial rates, and these transition procedures should include recognition of the investments and obligations incurred by the cable operators prior to the initial date of rate regulation. The Commission should also adopt a COS procedure as a "backstop" to the price cap formula, but the rules governing a COS backstop for changes in rates need not apply to the initial rates effective September 1, 1993.

In this paper, we develop and document the following conclusions which are of vital importance to the Group members as they make the transition to rate regulation:

I. COS rules for the initial rates should afford a cable operator the opportunity to establish initial rates without the burden of a full-scale COS showing.

II. All intangible assets reflected in a cable operator's records in accordance with generally accepted accounting principles (GAAP) should be included in any valuation of the "rate base" for the purpose of initializing regulated rates.

III. The COS rules should recognize and compensate for start-up investments made in the form of accumulated losses incurred prior to the effective date of regulations, including a return thereon.

IV. GAAP should be used as the basis for justifying historical expense levels and asset values. There is no need for Commission-prescribed depreciation and amortization rates.

V. Income taxes, computed at statutory rates, should be a permissible cost, regardless of the actual form of ownership of the subject cable system.

VI. COS procedures applicable to future years should provide a cable operator with an alternative to a full-scale COS showing.

I. COS rules for the initial rates should afford a cable operator the opportunity to establish initial rates without the burden of a full-scale COS showing.

For several reasons, discussed below, the Commission should allow cable operators to justify initial regulated rates based on simplified procedures. Such "streamlined" procedures will significantly reduce the cost of justifying initial rates.

A. There is no time to adopt traditional, standardized COS procedures for justifying initial rates.

We recommend that the Commission not adopt traditional, standardized procedures for justifying rates on the initial date of rate regulation. There is little time for development of detailed, standardized COS procedures. For many cable operators, the initial date of regulation for the programming tier of service will be in early September 1993, when a complaint is received at the Commission. The initial date of regulation for the basic tier is likely to be in October 1993 when franchising authorities apply immediately after September 1, 1993 for certification to regulate. Most cable operators must submit justification for rates in mid-November 1993, either a benchmark calculation or a COS showing. Therefore, studies must be done now in preparation for justifying initial rates.

Adoption of standardized procedures is difficult and time consuming, even when uniform accounting information is available. For example, COS procedures for interstate access charges for the LECs took more than a year to develop prior to implementation, and another year or so to adjust and fine tune after rates went into effect. Similarly, procedures for allocation of LEC costs between regulated and unregulated operations took years to develop and implement. In the case of the LECs, there was already a regulatory history, a uniform system of accounts and prescribed depreciation rates. There is no uniform system of accounts in the cable industry, no uniform depreciation rates, and no history of cost-based rate regulation.

Cable operators need to establish and justify the initial regulated rates in a timely manner. Prolonging this process for months or even years will add substantially to the cost of regulation, and will create additional uncertainty for consumers and lenders. The Commission should therefore establish special transition procedures for justifying initial rates.

B. Special transition procedures for justifying initial rates should recognize that substantial safeguards exist against artificial inflation of the initial rates.

Prior to November 15, 1993 rates are subject to the Commission's "rate freeze" order, which requires that the average customer bill not increase, except in certain limited circumstances (Order on *Implementation of Sections of the Cable Television Consumer Protection and Competition Act–Rate Regulation*, MM Docket 92-266, adopted June 11, 1993). Therefore, rates on the initial date of regulation will be subject to the Commission's rate freeze order. Transition procedures could allow a simplified COS showing for operators seeking to justify rates that are within the rate freeze guidelines. Where operators are seeking to justify rates above the rate freeze level, a more detailed COS showing could be required.

Simplified procedures could also be adopted for operators using a historical "test year" for COS showings, particularly where the historical financial information is taken from audited financial statements. Because cable rates have not been regulated under rate-base/rate-of-return procedures, cable operators have had no incentive to artificially inflate costs. To the contrary, their incentive has been to minimize costs. Therefore, the Commission should be able to rely on audited financial information for periods prior to regulation without risk that the costs are somehow inflated. A "streamlined" option for justifying initial rates could base all cost information on historical financial statements.

C. Special transition procedures for justifying initial rates should also recognize existing loan agreements, bond covenants, etc.

Cable operators enter regulation with existing loan agreements, bond covenants and other obligations to entities that have provided the capital required for system acquisitions, expansion, rebuilds, and improvements in service. Cable operators will have to rely on these same sources of capital in the future to finance upgrades, rebuilds and other improvements. If rate regulations cause reductions in cash flow large enough to put operators in default on existing agreements, operators will at best be required to incur additional fees and interest cost to renegotiate agreements, or at worst be subject to foreclosure.

The Commission's regulations should specify that initial rates should be high enough to allow operators to meet existing loan agreements and bond covenants. An example of such a procedure was recommended by Falcon Cable in its August 25, 1993 comments in this proceeding (Falcon Cable TV et al., Appendix A, "Marginal cash flow test as a rate analysis mechanism short of cost-of-service regulation"). Before requiring a cable operator to justify rates with a full-blown COS showing, the Commission should allow a simplified test that permits the cable operator to have rates that permit it to meet existing debt obligations.

D. Special transition procedures should include simplified cost allocations.

For initializing rates, the Commission should not prescribe detailed cost allocation procedures, cost accounting manuals, etc. as it has done for the LECs. Rather, the Commission should allow operators to use simplified procedures of the type already included in paragraph 76.924 of the *Rules and Regulations*. Such procedures will allow operators to justify rates in a timely fashion without the cost and delay that would be caused by attempts to establish detailed procedures. Per channel or subscriber-weighted per channel allocations are examples of allocation factors that are readily available to cable operators using existing information, and these factors should be considered acceptable for allocating costs in simplified studies for justifying initial rates.